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New Zealand's Lange Tilts at Economic Problems

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An Intelligence Assessment

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An Intelligence Assessment

This paper was prepared by [redacted] Office of East Asian Analysis, with contributions from Tim Flannery, Office of Central Reference. Comments and queries are welcome and may be directed to the Chief, Southeast Asia Division, OEA [redacted]

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Key Judgments

Information available as of 20 April 1985 was used in this report.

Although ANZUS and the denial of port access to US ships have dominated press coverage of Prime Minister Lange since he came to office, we believe the electorate ultimately will judge the Labor government by its progress in dealing with the country's serious economic problems. Thus far, a modest economic recovery since Lange assumed office in July 1984 has allowed the Labor Party's conservative team of economic technocrats to begin sweeping reforms designed to improve New Zealand's international competitiveness and to regain its declining share of world trade:

- Devaluing and later floating the New Zealand dollar.
- Removing price and interest rate controls.
- Liberalizing restrictions on international flows of capital.
- Lowering import barriers.
- Reducing farm subsidies.
- Raising taxes and charges for government services.

The reform agenda also includes limiting the power of the trade unions and overhauling the tax system. 25X1

The government's economic policies underscore the fundamental philosophical differences that separate Lange's approach from that of many of Labor's traditional supporters—who favor protecting indigenous industry and jobs and increasing spending on social welfare. Nonetheless, we believe Lange has gained a breathing space in the party caucus and a free rein on economic policy matters because his strong antinuclear stand far exceeded the expectations of party leftists. 25X1

Lange appears to be having more serious political difficulties outside the party. Farmers and pensioners, traditional supporters of the opposition National Party, are particularly disgruntled with Labor's harsh November budget. Public opinion polls show that the National Party's popularity has steadily increased since then, and in April it edged ahead of the Labor Party by 2 percentage points. 25X1

We do not expect Lange to stand firm on continuing his economic reform program during the remainder of his three-year term. We believe only sustained economic growth on the order of 3 to 4 percent annually—an unlikely prospect according to our analysis—would deter union leaders and leftist party ideologues from demanding a return to policies of stimulating the domestic economy, despite the risk of accelerating inflation. If the economy sputters, as seems likely, and the Labor government is blamed, the National Party would be in a good position to return to power in the 1987 national elections. 25X1

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New Zealand's Lange Tilts at Economic Problems

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Lange's Political Mandate

Although foreign policy issues—chiefly ANZUS and the denial of port access to US naval ships—have dominated press coverage of Prime Minister David Lange's first nine months in office, we believe that the electorate will judge the Labor government on the basis of domestic issues, chiefly the economy. Lange, we believe, fully appreciates this economic imperative. Labor's election rhetoric stressed economic growth and hit hard at former Prime Minister Muldoon's expensive social welfare policies.[1] Moreover, when Lange took office last July he immediately acted on his campaign theme of "Bringing New Zealand Together" by calling for an economic summit, which was held in September. Business, labor, and government representatives—invited to participate in formulating the new government's economic policies—provided Lange a media extravaganza. Soon after the election he also assembled a respected team of technocrats, giving the finance portfolio to Roger Douglas, his most conservative Cabinet minister, and appointing two other members of Parliament with economic and financial expertise to assist the new Finance Minister.

Lange's ability to continue his economic reform is closely bound to his strength as party leader. Although he has always had problems with the left wing—which opposes market-oriented reform initiatives—his position in the Labor Party parliamentary caucus has improved since August.[2] We believe the principal reason for the improvement is Lange's foreign policy: his uncompromising ban on port calls by nuclear-weapons-capable warships has satisfied one of the left wing's primary demands. This has won Lange a breathing space in economic policy making—although, in our judgment, such a tradeoff is unlikely to satisfy the left much longer.

[2] The US Embassy estimated in August that only 26 of the 56 Labor parliamentarians supported Lange, while 24 supported left-wing leader Jim Anderton and six were nonaligned. Several first-term parliamentarians have since abandoned Anderton for Lange, with whom they may prefer to link their political fortunes, and strong Anderton supporters now number only 15.

The Road to Moderation: First Steps

Lange's progress thus far has been impressive. The Labor government's first economic objective upon taking office was to end the ruinous speculation against the New Zealand currency that had developed in the second quarter of 1984. It immediately devalued the New Zealand dollar—a move Muldoon had resisted for months. At the same time, the government eliminated Muldoon's tangled web of interest rate controls; that, together with the devaluation, sparked a dramatic resurgence in capital inflows, as New Zealand government and private securities began to look attractive to overseas investors.[3] To entice investors from New Zealand's two leading trading partners the government also sponsored showcase tours for Japanese investors and lifted the Muldoon government's embargo on Australian private investment.

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When he announced the 1984-85 budget in early November, Finance Minister Douglas served notice that the new government was about to push for real change in New Zealand's economic structure. The budget attempts to combine Douglas's conservative economic principles with the Labor Party's traditionally liberal aims by addressing three primary goals:

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- Reducing the budget deficit.
- Restoring export competitiveness.
- Extending the safety net of social welfare programs.

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The Labor government, in our view, has made impressive progress putting the government's finances in order. On the revenue side, the budget raises the average income tax, closes several cherished tax loopholes, taxes fringe benefits, places a surtax on high-income pensioners, and increases the excise taxes on

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[3] Devaluation resulted in an immediate reversal of domestic liquidity conditions. Trading bank reserve assets, reflecting the large postdevaluation inflow of funds, rose by more than US $460 million during July and by early August reached a record of about US $1.4 billion, according to the Reserve Bank of New Zealand.

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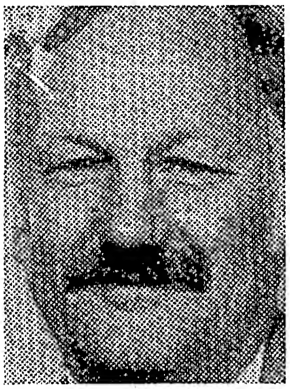
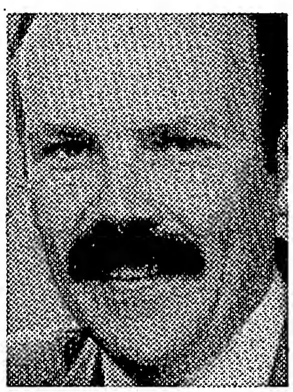
Lange's Economic Triumvirate



Finance Minister ***Roger Douglas*** *is a maverick within the Labor Party because of his "growth first" economic views. A successful businessman, the outspoken Douglas has clashed with party leaders in the past but is on good terms with Lange, who admires his innovative ideas. An accountant by training, Douglas is 48 years old.* 25X1

Associate Minister for Finance ***Richard Prebble*** *is a close adviser to Lange and an excellent pro-Lange coalition builder. He is also a harsh critic of past Labor Party leadership. Energetic and aggressive, he holds transport-related portfolios and is Minister for Pacific Island Affairs. A lawyer, he is 37 years old.* 25X1



Associate Minister for Finance and Minister of Trade and Industry ***David Caygill*** *was once a supporter of the radical-left faction of the Labor Party but is now a full partner in Lange's economic planning group. He believes New Zealand's industrial base must be redirected away from noncompetitive activities and toward highly sophisticated technological products. A lawyer, Caygill is about 35 years old.* 25X1

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Economic Reform: A Herculean Undertaking

Lange's mandate to restore the economy to health and to streamline the maze of ad hoc policies left by Muldoon provides him with a major challenge. Since 1955—when New Zealanders had the third-highest per capita income in the world—moves by a series of protectionist governments have helped to lower the country to about the 20th position, where it has hovered in recent years, according to the World Bank. [redacted]

Especially during the Muldoon years (1975-84), New Zealand avoided putting its resources where they could earn the most in the world economy. When cheaper Asian-manufactured goods began to flood home markets during the 1970s, for example, Muldoon developed import-licensing and export-subsidizing schemes that effectively protected New Zealand manufacturers but directed resources toward industries where New Zealand had no competitive edge, such as automobile and electrical equipment assembly. When world agriculture prices dropped, New Zealand added farm subsidies, which over time have distorted the pattern of land use and have led to increased production on marginal land of commodities that are already in surplus in world markets, such as dairy products. [redacted]

Muldoon's critics accused him—correctly, in our view—of treating the symptoms of New Zealand's malaise rather than its causes. Under Muldoon, Wellington "solved" the problem of high inflation with price controls, the problem of high interest rates with interest rate ceilings, and the problem of high wage settlements with across-the-board wage increases that were more moderate but ignored market demand and, later, with wage freezes. To make matters worse, Muldoon resorted to an erratic fiscal policy. Real government expenditures invariably rose during election years, while real revenue collections fell; after elections, the process was reversed. [redacted] 25X1 25X1

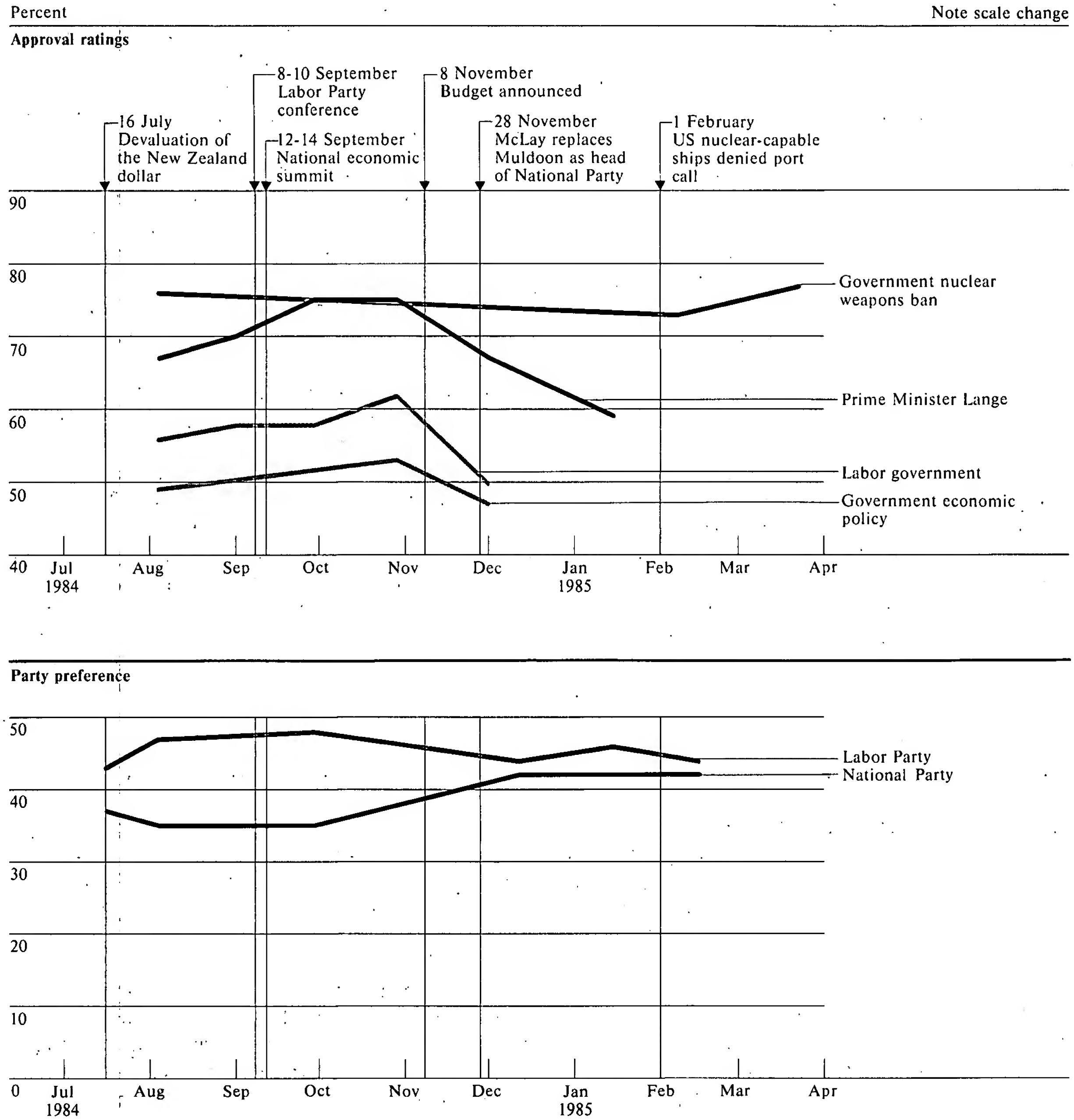
In perpetuating the welfare state, Muldoon committed the government to providing more goods and services than it was prepared to tax the public for. Food, transportation, postage, and hospital care have been subsidized for decades. Under Muldoon, however, social welfare programs expanded rapidly to include a new national retirement scheme and a more liberal unemployment insurance program. Thus, over the last 15 years government expenditures have risen more than tenfold, and, in the last year of Muldoon's leadership, government expenditures exceeded 40 percent of gross domestic product while the government deficit reached nearly 9 percent of GDP. [redacted] 25X1 25X1

alcohol and cigarettes. It also requires government-owned enterprises such as an oil exploration firm and the post office to return more of their earnings to the government and raises user fees for roads and airports. [redacted] 25X1

On the expenditure side, the budget ends consumer subsidies on goods such as coal, gasoline, and electricity. The largest chunk of budget savings, however, comes from reducing the subsidies that have supported farmers and traditional export industries for years. Douglas, according to press interviews, is convinced that expensive subsidies are bankrupting New Zealand and encouraging inefficient business ventures. His approach is aimed at reducing both the deficit and government intervention in the marketplace. Besides outlining a plan to reduce the tariff structure over several years, the budget immediately increases import license allocations to allow more competition in the domestic market. [redacted] 25X1

Lange's policymakers have also exhibited considerable political savvy in dealing with labor, in our judgment. Knowing the government would face wage negotiations in December 1984—at the end of a three-year wage freeze—Douglas at budget time tried to preempt one of the unions' major arguments for a

Figure 1
New Zealand: Polling the Public on Politics



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large wage increase: that low-paid workers were unable to support their families at current wage rates. His family care package, therefore, gives about $5 weekly to low-income working families.[4] Together with hikes in social security and other payments, the benefit package will result in a 9.2-percent rise in budget expenditures, but the 15-percent increase in receipts predicted by the government is supposed to shrink the deficit.

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Public Reaction

Despite the pinch of higher gasoline and import prices resulting from devaluation, the public has given the government credit for acting decisively in its first months in office. Pollsters recorded a significant increase in support for the Labor Party during the weeks following the election, and after the September economic summit both the Labor government and Lange received their highest popularity ratings (see figure 1).

Since then, the road has been rockier. Reaction to the long-awaited budget, for example, was sharp, immediate, and mostly adverse. Although opposition to the budget has been tempered by the widespread realization that the Muldoon government left the country with serious economic problems, every major interest group—ranging from farmers to retirees to union leaders—has complained about particular provisions.

The offended groups include voters in both major parties. Editorials, letters, and public opinion polls have registered particular discontent among traditional supporters of the opposition National Party. Even among Labor Party stalwarts, however, the government's budget has ruffled feathers. Many union leaders have complained that the government's policies require taxpayers rather than business profits to provide aid to the needy. They had expected, we believe, Lange and Douglas to provide tax relief for all wage and salary earners in exchange for the promises they made at the September summit to demand only moderate wage increases in the December negotiations.

[4] Unless noted, all dollar figures are in US dollars and are based on the 5 April conversion rate of NZ $1.00 = US $0.46.

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As Santa Lange came to town with his bag of budget goodies, the pouting began. *The New Zealand Herald ©*

The Crusade Continues

Lange's government appears determined to press on, despite opposition from key political constituencies, and the next target will probably be the wage-setting process. The US Embassy reports that, after recently studying work force dynamics in the United States, Douglas has concluded that the primary reason for the almost total absence of new job generation in New Zealand during the last two decades has been the inflexibility of the work force. Indeed, government coercion in the wage-setting process has all but ruled out corporate- and industry-level collective bargaining. High across-the-board wage settlements in the 1970s resulted in minimum wages that are too high relative to the skills required in many jobs, according to Douglas. He says unemployment compensation has been too liberal and many workers are simply unwilling to take low-paying jobs.

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Douglas already has had partial success in implementing labor market reforms. Union and business representatives have approved a new, more flexible framework for wage negotiations:

- Encouraging enterprise- and industry-level bargaining.
- Taking into account supply and demand for particular skills and changes in job content or technological levels which result in greater productivity.
- Reducing the government's role and increasing the roles of the Arbitration Court, employers, and local union organizations.

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In December, however, union leaders' disappointment with the government's budget threatened the first trial of the new system. Because union and business leaders were unable to agree in advance upon a wage increase target, Lange acted in a "Muldoon-like" manner, imposing on negotiators a wage-increase target of 4 to 5 percent and hinting about wage fixing if bargainers ignored it. Political observers predicted bitter disputes: the Federation of Labor endorsed a minimum settlement guideline of 9.6 percent and employer representatives stated they would return to their original offer of 2 percent. Although these disputes never materialized, wage settlements have averaged about 7 percent, and we judge that Lange will face a serious challenge from unions when the next round of wage negotiations begins in September—primarily because inflation is increasing again, but partly because the wage round will be a convenient time to express displeasure with the government's overall economic program. 25X1

Also on the government's agenda is a major overhaul of the entire tax structure to incorporate some of Douglas's ideas. As recently as two years ago Douglas suggested reforms considered radical by New Zealanders, including abolishing personal and company income taxes and replacing them with a flat rate payroll tax (on wages, allowances, and "perks"), and taxes on some business inputs, gifts, retail merchandise, and wealth. According to Douglas, the present system of relying heavily on personal income taxes with steep marginal rates discourages productive investment and risk-taking and leads to tax avoidance. It is also ineffective in collecting revenue because a great majority of the New Zealand work force has an income close to the average annual wage of $11,500 and few individuals pay the high marginal tax rates. Douglas took the first step toward implementing his ideas in April 1985 when he introduced in Parliament a bill for a broadly based value-added tax. He has promised to follow up with a large across-the-board cut in income tax rates, but spending requirements may limit such cuts. 25X1

The government apparently will implement many of Muldoon's ideas for export marketing, including the creation of a new Department of Overseas Marketing to develop a global export strategy. On the other hand, Labor's energy policy questions the value of Muldoon's "think big" energy development projects—designed to substitute domestically produced synthetic gas and gasoline for oil imports (see table). Future projects, says Douglas, will have to operate without government subsidy—a move that assures higher energy prices. 25X1

New Zealand: Cost Estimates for Major Projects, February 1984 [a]

Million US $

Project	Construction Period	Cost
Total		**3,780**
Energy projects		2,410
Marsden Point oil refinery expansion	1980-84 [b]	780
Motunui synthetic gasoline plant	1982-85	620
Petralgas chemical-methanol plant	Completed	455
Petrocorp LPG-to-fuels plant	1983-85	220
CNG auto conversion (150,000 vehicles over 5 years)	1979-84 [b]	130
Petrocorp gas treatment plant	1983-85	80
Liquigas LPG distribution	1981-88	65
Kapuni ammonia urea plant	Completed	60
Ethane processing plant	Late 1980s	NA
Other projects		1,370

[a] Cost overruns and construction delays, especially at the Marsden Point refinery, have discouraged the Labor government, according to press reports. Moreover, falling world oil prices make the energy projects seem less necessary, and there have been rumblings in the press, supposedly originating within the government, about discontinuing the more costly and less complete parts of the "think big" program.
[b] Extended.

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Assessing the Short-Term Economic Costs . . .

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Although reform eventually will improve international competitiveness and growth, the next two years will see upheaval as Labor's moves begin to take their toll

Money, Credit, and Debt:
New Zealand Down, but Not Out

The Labor government faces its most critical problem of economic management in matters of money and credit. Public-sector debt is reaching $15.6 billion, with overseas obligations totaling about $9.1 billion, according to the US Embassy. The ratio of debt to GDP has placed New Zealand on par with such debt-ridden nations as Brazil and Mexico, and its credit rating has been lowered twice since 1982 by international rating services. The high cost of debt service—15 percent of government expenditures or 20 percent of revenue—limits Labor's monetary and fiscal policy options.

Beginning with devaluation of the New Zealand dollar in July, Douglas has introduced a series of measures to strengthen the financial sector by building up foreign exchange reserves, freeing interest rates, liberalizing barriers on international flows of capital, and allowing an increase in the number of foreign exchange dealers. Partly for this reason, New Zealand has had no trouble arranging foreign financing for a current account deficit that, according to the US Embassy, increased by $330 million to reach $1.4 billion in the year ending in December 1984. Its imaginative debt rollover in September impressed many foreign economic analysts; one long-term and three short-term borrowing options were created, each providing a full $1.4 billion.

Volatile trading of the New Zealand dollar on financial markets in February 1985—possibly caused by fear of US trade sanctions in the wake of the ANZUS port access crisis—encouraged Douglas to announce on 4 March the float of the dollar he had been preparing for months. Because the float has produced no marked revaluation of the currency in trading since then, Douglas has been able to fend off criticism that it would harm exporters and risk external manipulation of the exchange rate. The float will allow the Lange government greater flexibility in controlling inflation—which economic analysts had 25X1 *forecast to reach an annual rate of 14 percent by June 1985—and in managing foreign debt financing.*

25X1 *Moreover, we believe Douglas could continue imposing his conservative economic policies on the often-fractious Labor Party caucus if he succeeds in moderating inflation and achieving modest growth. The party's left wing has charged that monetarists have overtaken the Labor government and overturned long-standing Labor Party priorities. The left, we believe, is anxiously awaiting the right moment to demand a return to traditional policies of regulating financial markets, stimulating the domestic economy, and protecting jobs.* 25X1

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on less efficient businesses. The manufacturing sector, we believe, will grow only by fits and starts. An industrial shakeout and the curtailment of large subsidies will inevitably lead to job losses, and, in the uncertainty surrounding economic reform, new employment opportunities are not likely to be created in sufficient numbers to absorb displaced workers.

Lange publicly has acknowledged that labor-management tensions are inevitable in a climate of rapid change such as he is attempting to instigate. New Zealanders, however, are usually not very tolerant of strikes—apparently the main reason they accepted Muldoon's reversal of the policy of compulsory unionism. For this reason, we believe the Labor government, which has reinstated compulsory unionism and can less afford to offend the union movement, may be persuaded to reintroduce some subsidies and import barriers to quiet labor protests if the public complains. 25X1

In the agricultural sector, Labor's subsidy cuts almost certainly will eliminate marginally profitable farms. New markets such as China and reasonably good world prices will bring profits to New Zealand wool and beef producers again this year, but a potential 25X1

price war involving US and EC dairy products threatens New Zealand dairy farmers. In addition, farmers continue to be concerned about US trade sanctions following Lange's port ban policy—a reasonable fear since the United States is New Zealand's largest overseas customer.

. . . and the Political Fallout

Fundamental philosophical differences clearly separate Lange and his finance team from many of Labor's traditional supporters, and we believe this will prove to be Lange's Achilles' heel. The government's policies presuppose that the New Zealand economy should be export led and must, therefore, be competitive in world markets. Union leaders have consistently opposed this point of view, charging that it requires a low-paid labor force and exposes New Zealand to the vagaries of demand and inflation of the global economy. They contend that the best course for New Zealand is to stimulate the domestic economy and continue to protect indigenous industry and jobs. Thus, their argument runs, the government should have a key role in directing domestic investment and in regulating the economy.

With economic growth slowing this year to less than 1 percent—probably to be followed by two or three years of little or no growth before the government's reforms reinvigorate the economy—Lange must expect a serious challenge from the Labor Party's rank and file as well as from union leaders.[5] Party leftists will continue to be Lange's biggest worry, exasperated by his forsaking of the party's traditional interventionist, job-protective, and welfare-oriented approach to economic policy.

Outside his party, Lange also faces increased pressures from a refurbished National Party. The National Party deposed leader Muldoon last November—despite his efforts to retain party leadership. Since then, the National Party's popularity has steadily increased, and in late April public opinion polls it moved ahead of the Labor Party, 44 to 42 percent. Furthermore, polls indicate a sizable drop in support for Bob Jones' free market New Zealand Party, with many of its supporters drifting back into the National camp.[6]

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Political observers have come to consider National the "natural" ruling party in New Zealand because not one Labor government has won a second term since World War II. Moreover, farmers are generally a National constituency and about half of New Zealand's jobs are still in the agricultural sector. Lange rightly says that farmers must cut costs and diversify if agricultural exports are to remain New Zealand's primary source of foreign exchange earnings. As in all industrialized nations, however, many New Zealand farmers will be forced to find new careers. The potential political backlash is not a happy prospect for Lange—who publicly admits knowing little about farming.

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If the economy sputters—an outcome we deem likely—the loss of some Labor supporters plus the return of businessmen, professionals, and disgruntled farmers to the National Party could cost Lange and the Labor Party its control of government in the 1987 election. We believe a variety of indicators will be available in the months ahead to gauge the outcome, including:

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- ***The regional Labor Party conferences.*** Dissension at the first of six conferences in March underscores Lange's tenuous hold over economic policy making. Party members passed resolutions—which are preliminary drafts of party policies—against the government's proposed goods-and-services tax and its market-oriented budget. If moderates fail to curb leftwing demands at the remaining conferences, it

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[5] We believe the economic growth of nearly 4 percent that New Zealand registered in 1984 is unlikely to be repeated because it was primarily a response to the world recovery—export earnings rose for wool, nontraditional primary products, forestry products, and manufactures. Moreover, the devaluation and domestic deregulation brought in a surge of new capital in the last half of the year that is unlikely to be repeated. This year, the export volumes of most products are not expected to increase dramatically, according to New Zealand and Australian economic analysts, and dairy product exports are expected to fall.

[6] The New Zealand Party was formed in 1983 to offer an alternative to what its leader, Bob Jones, called the socialist and interventionist policies of the National Party government under Muldoon. In addition to free market economic policies, it advocates the dismantling of the nation's defense forces. In the July 1984 elections, it garnered 13 percent of the popular vote, drawing away from the National Party many businessmen, professionals, and farmers disenchanted with Muldoon's welfare-state approach to economic management.

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would be a major setback for Lange, because subsequent rounds of policymaking will be influenced by the left through its control of the party machinery. Resolutions passed must be approved at several levels before they become party policies, but the parliamentary caucus is obliged to implement party policies and may convert them into law.[7]

- ***Defense spending and taxation.*** Military spending must rise—"more than 1 million but less than 1 billion" New Zealand dollars, according to Lange—to cover the added costs of maintaining an adequate defense without US cooperation under ANZUS. Although lowering the overall tax burden and making New Zealand's tax system more equitable have been Douglas's primary aims, increased defense spending will probably force him to use tax reform to increase revenue. Douglas's plan may therefore be of marginal benefit to the New Zealand economy while creating a public backlash.

- ***The opposition.*** Thus far, National Party leader McLay has been ineffective in his attempts to embarrass the Lange government over ANZUS and has offered no appealing alternative to Labor's economic policies. Among National supporters, moreover, former Prime Minister Muldoon continues to rival McLay in popularity. National will become a serious threat to Lange only when McLay exerts stronger leadership and focuses his attack.

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[7] Although Lange has managed to keep leftwing parliamentarians out of his Cabinet, they are very vocal in the caucus, continue to have disproportionate influence in the party organization, and are therefore able to skew the regional and national party conferences toward more radical positions than the Lange faction would prefer.

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